March 20, 2012

LFC Investment Report for the Quarter Ending December 2011

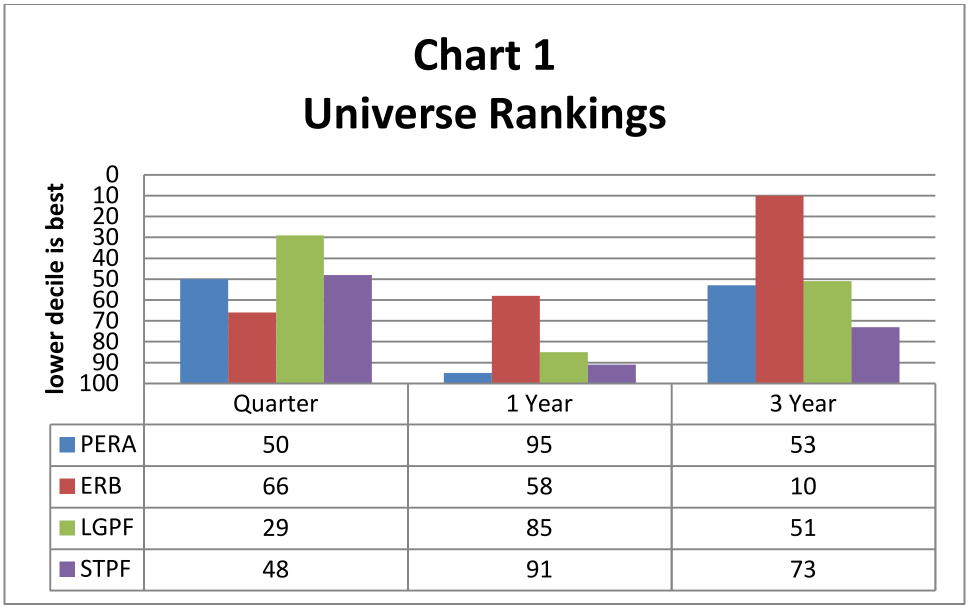
This report details the comparative investment performance of the three investment agencies: the State Investment Council (SIC), the Public Employees Retirement Association (PERA) and the Educational Retirement Board (ERB). It explains how the returns generated by the three investment agencies differed from that of the archetypical fund and how their management and consultants added and subtracted value.

Table 1 shows percentage returns and ending balances. The returns and balances of the Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are shown separately. A portion of the STPF is invested in economically targeted investments that yield below market returns; the LGPF does not have economically targeted investments in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives. For the quarter ending December 2011, economically targeted investments cost the state $23 million in foregone income.

Table 1

Returns and Ending Balances				
	PERA	ERB	LGPF	STPF
Return (%)	4.97	4.40	5.23	4.59
Ending Balance ($B)	11.319	8.996	10.330	3.616

Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, year-to-date and over a three year period. A lower rank (1st is best) denotes a better performance when compared to other funds. ERB & SIC are compared against all public funds with assets greater than one billion dollars while PERA's return is compared against funds greater than two billion dollars. This analysis concentrates on LGPF's return; it would be unfair to penalize SIC for legally mandated (or encouraged) below-market investments. LFC staff is currently working with consultants to find a common peer universe for all funds.



	Quarter	1 Year	3 Year
PERA	50	95	53
ERB	66	58	10
LGPF	29	85	51
STPF	48	91	73

For the quarter, PERA turned in a return in the middle of the pack. This is consistent with their longer term performance and over their year-to-date results, which are poor. SIC's return placed it in the 2nd quartile for the quarter. This is in contrast to their year-to-date performance which ranks in the 91st percentile and their three-year average which is middling. ERB returned a middling to below average performance. This is consistent with their year-to-date performance and contrasts with their three-year performance, which is very good.

While this report necessarily concentrates on the quarter and can serve as a baseline, long term performance is indeed the most important metric. Future reports will attempt to analyze individual fund's long term performance in detail.

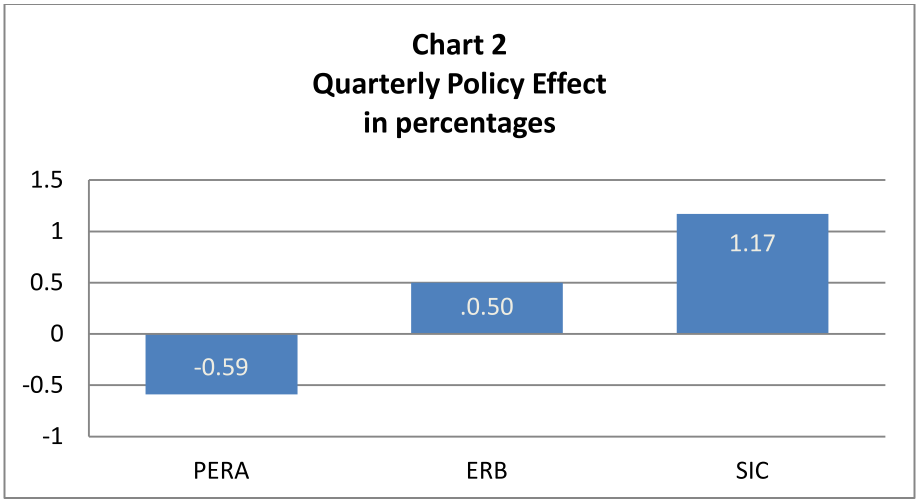
Attribution Analysis

There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Quarterly Policy Effect

The first is that a fund can have a long term policy allocation (known as the "policy index") benchmark that has a more or less aggressive proportion of risky assets such as stocks. For example, risky domestic assets such as US stocks (equities) performed best in the 4th quarter. Accordingly, an index that has more domestic equities should outperform the average. Measured in isolation, this is known as the "policy effect" and is very much an essential responsibility of the fund's trustees. The most appropriate measurement of a policy allocation benchmark is comparison to a defined peer group.

Chart 2 shows the funds' policy effect as measured against the average return of all public funds with assets greater than one billion dollars.

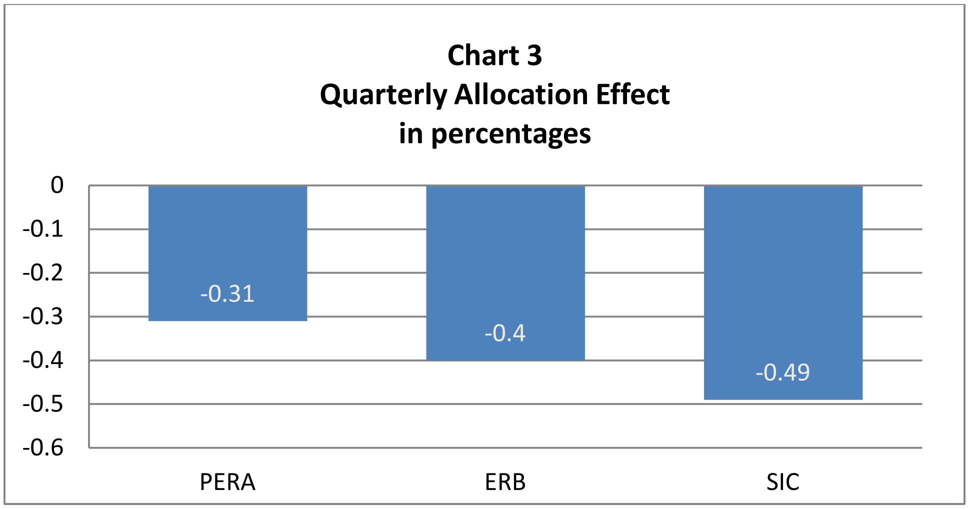


In isolation, PERA's policy should yield 0.59 percent less than the average fund. This is because their index holds more international equities than is normal; international equities lagged domestic equities during the 4th quarter. ERB benefitted from its policy index because it holds a large proportion of its fixed income portfolio in risky strategies (specifically "opportunistic credit") during a quarter when the market rewarded risk. SIC's policy index is heavily weighted toward domestic risky assets such as domestic equity and, in isolation, should deliver (relatively) very high returns.

<u>Quarterly Allocation Effect</u>

The second way that a fund's return can be affected is by tactically shifting assets away from the proportions called for by policy. This is arguably the best measure of the value added from a chief investment officer. For example, an investment officer might have had a bearish view of the stock market during the 4th quarter and used his authority to temporarily reduce a fund's risky assets to less than what is specified in policy. Since stocks had a good quarter, reducing risky assets would have been a bad market call and would have subtracted from fund performance. As a matter of practice, investment officers are constantly confronted with allocation decisions come up when transitioning or rebalancing portfolio managers or asset classes. The investment officer may have the option of letting the money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. Tactical investment authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

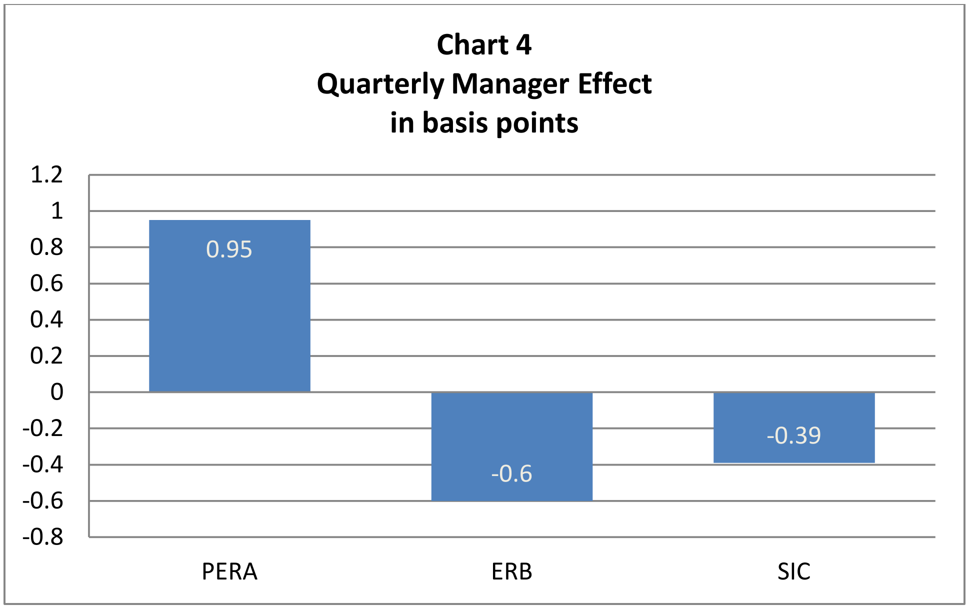
The difference between the funds temporary and long term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Chart 3 shows the quarterly effect graphically; all three funds lost value by deviating from their policy index. ERB's return would have been 0.40 percent higher but for rebalancing decisions. SIC's returns would have been 0.49 higher but for the value lost by deviating from policy. PERA lost 0.31 percent from the market effect of a slight overweight to fixed income and a slight underweight to domestic equities. Again, it needs to be emphasized that allocation gains or losses occur constantly. Asset proportions vary against targets because of market price changes and incoming and outgoing cash flows, which are also variable. How staff deals with these factors is the "inside baseball" of fund management and has significant effect on performance.



Quarterly Manager Effect

The third way that value can be added or subtracted from a fund is through the use of active management. For example, a fund can buy a security such as the institutional version of the Standard & Poors Depository Receipts (SPDRS) commonly used by retail investors. These securities are composed of a relatively fixed basket of securities that track the S&P 500 index. Alternatively, the fund can employ a manager who will trade individual securities given his attitude about the prospects of individual stocks. This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect".

As Chart 4 shows, PERA's managers' added 0.92 percent to return. Managers for ERB and SIC subtracted 0.60 percent and 0.39 percent from returns, respectively. PERA's quarterly report shows their managers performing very well gross of fees, primarily due to active management in the fixed income and domestic small/mid cap equity asset classes. For ERB, a substantial portion of the loss came from hedge funds. These are partnerships that invest in "exotic" strategies that often involve options and futures markets. The loss to the SIC was mostly generated in equity managers. Of particular note is the performance of SIC's large cap equity manager, Thornburg Management. Net of fees, Thornburg missed its benchmark for the quarter by a whopping 4.73 percent and its year-to-date performance is off 13.73 percent.



The funds' 4th quarter performance can be summarized as follows:

- It is difficult to rank the funds ordinally because of funds using different peer universes. Given the fact there is no significant theoretical reason for different peer groups, this will be revised in the next report.
- PERA's return was average for the quarter. Their emphasis on international equity put the fund at a slight disadvantage to other funds. PERA's temporary deviation from long-term allocation targets due to market impact resulted in lost value. However, superior active investment management offset these negative impacts.
- ERB turned in a performance that was below average even though their emphasis on risky debt strategies put them at an advantage for the quarter. However, this advantage was negated by rebalancing decisions and poor hedge fund performance.
- SIC quarterly performance was above average. SIC's policy index put them in an extremely good position to benefit from a rally in risk assets. However, temporary deviations from their policy and poor equity manager performance muted the advantage gained from the SIC's policy index.